AUCTION RATE SECURITIES PRIMER

ARS

Various institutions that seek long-term funding have the option of issuing debt through the auction rate securities (ARS) markets. An underwriter will assist an issuer - such as a closed-end fund, a municipal entity, a student loan issuer like Sallie Mae, or a non-profit organization - in issuing and selling these securities. ARS are sold at par (or on a dollar basis), with an interest rate that resets at specified intervals every 7, 14, 28, or 35 days through an auction process described below.

Liquidity and Mechanics of ARS Auctions

Investors in this market (through the purchase of an ARS) would normally expect to exit the market at par upon sale of their ARS, earning the applicable interest payment for the period they were invested, *provided there is a bidder,* that is willing to buy and hold the ARS until another subsequent auction, weeks or months later.

Prospective purchasers of ARS would submit their bids for the par amount of the ARS they wished to buy. The interest rate on the ARS sets through a bidding process and is determined by the lowest rate at which all prospective holders are willing to invest. This is called the Clearing Rate.

Generally, interest rates on ARS were determined based on a reference rate like LIBOR. In the instance of a failed auction, where there are not enough bidders willing to buy, or an auction for which there are no bidders, a default “failure rate” typically was set by a predetermined formula specific to that issue.

Auction Agents

ARS auction procedures are managed by a bank or trust company (Auction “Agent”). Auction agents collect bids, enforce auction deadlines, and operate as custodians.

Broker dealers

Broker-dealers are hired by issuers to serve as dealers for ARS auctions. Broker-dealers are generally paid by the issuers pursuant to Broker-Dealer Agreements which govern the applicable bidding deadlines and auction procedures. Some ARS programs have a single broker-dealer and some involve multiple dealers.

Auctions have been coordinated through broker-dealers that regularly submitted their own bids for their own accounts during auctions to prevent those auctions from failing. This ARS inventory may have been subsequently sold to current retail investors.

Lack of Liquidity

ARS liquidity evaporated on or around February 13, 2008. It is not clear if the auction markets will function properly again.

Before February 13, 2008, investors both small and large had relied on the relatively smooth functioning of the auction mechanisms provided by and through the major broker-dealers since about 1988.

When dealers stepped back in February 2008 from the market, the ARS auctions froze. As of April 2008, the market remains largely frozen despite recent redemptions of ARS by some closed end funds.

Prior SEC Actions

Historically, there have been concerns about ARS auctions and their lack of transparency. Auctions have been deemed to have been manipulated by key participants in the past, and the SEC sanctioned the major players in 2006 and 2007.[1]

Default Interest Rates

Because of the extraordinary turmoil in the banking system and the failure of almost all of the relevant auctions since February 2008, certain non-profit hospitals and municipal issuers have seen their ARS interest expenses rocket from 4% to about 18%. The offering documents for ARS included these "failure rates" that are now causing such difficulty for municipal borrowers. Closed-end funds that have used the ARS market as a means of leverage pay less severe penalty rates upon auction failures. It appears that failures cause the closed-end issuers to pay an extra 1-3% beyond their normal interest expenses.

Retail Investors and Liquidity

ARS were marketed and sold as "money market equivalents" or "cash equivalents" to investors. Financial advisers and brokers sold ARS to clients in $25,000 units, earning commissions that continue to accrue for as long as the investors hold their ARS. Brokers are still being paid commissions with the ARS freeze. Investors throughout the United States were told that ARS was "just as good as cash" and just as safe as any money market investment.

[1] See http://www.sec.gov/news/press/2006/2006-83.htm
http://www.sec.gov/litigation/admin/2006/33-8684.pdf